

Pension Schemes Act 2021: a guide to the new scheme funding requirements – funding for the longer term

In this our second briefing on the Pension Schemes Act 2021 (the **Act**), we set out the changes under the Act to the statutory scheme funding regime for defined benefit (**DB**) pension schemes and the Pensions Regulator's (**tPR**) new DB Funding Code. For our first briefing which covered changes to the Pensions Regulator's "anti-avoidance powers" and the impact on corporate activity, click [here](#).

Trustees of DB schemes will now need to determine a long-term funding objective (**LTO**) for the scheme to ensure benefits can be paid over the long term. TPR expects trustees to set an LTO that, by the time the scheme is significantly mature (15-20 years for many schemes), it is fully funded with low dependency on the employer.

Many schemes already have an LTO (some with a staged path to a "buy-out" of scheme members' benefits with an insurance company) – these schemes will still need to comply with the detailed requirements of the new regime. The new requirements are likely to impose significant additional burdens on schemes that do not have an LTO with some sponsoring employers having to pay significantly more into their schemes in order to meet the new long-term funding requirements.

Completing the funding picture, tPR is to issue a new DB Funding Code. Expected to be in place in late 2022 or early 2023, a significant change under the new Code will be the introduction of a "twin-track" approach to triennial scheme valuations.



What are the new statutory requirements?

Trustees of schemes that provide DB benefits will need to:

- determine an LTO for the scheme for ensuring that benefits can be paid over the long term;
- put in place an investment strategy that supports the LTO; and
- prepare a written statement on their strategy (covering certain prescribed information).

Pensions Regulator DB Funding Code

TPR will issue a new DB Funding Code, the first consultation on which was issued on 3 March 2020. The consultation covered:

- tPR's new proposed regulatory approach;
- the principles underpinning the new framework; and
- how the principles could be applied in practice to provide clearer guidelines.

In its consultation, tPR also proposed a twin-track compliance route to carrying out valuations: a "fast track" and "bespoke" route. The second consultation from tPR (which will include the new draft code of practice as well as details of its proposed regulatory approach) is expected at the end of 2021. The second consultation is also expected to provide guidance on "grey areas" under the regime, such as what is "prudent" in the context of the scheme's technical provisions and what is meant by "appropriate" in the context of a deficit recovery plan, which it is expected the new regulations will also clarify.

Timing

It is unlikely that the revised regime under the Act will be introduced until early 2022 (with implementing regulations expected this year to set out when the new requirements will need to be met). TPR has also confirmed that actuarial valuations will only come under the new DB Funding Code once the new Code has been issued. So, for actuarial valuations currently or soon to be under way and potentially those conducted in the first quarter of 2022, they will come under the new Code. We recommend, however, that both trustees and sponsors start to consider the principles in their funding decisions.

The new long-term funding requirements – a closer look

Funding and investment strategy

Under the new statutory requirements, trustees will need to prepare and revise a long-term funding and investment strategy for ensuring that pensions and other benefits can be provided over the long term. The strategy must specify:

- the funding level (this is the ratio of the scheme's assets to its liabilities) that the trustees intend the scheme to have achieved as at the "relevant date" (to be set out in implementing regulations); and
- the investments that the trustees intend to hold on that date.

In most cases, trustees will need to agree the funding and investment strategy with the scheme employer.

The written statement

The trustees will, as soon as practicable after determining, or revising, the funding and investment strategy, prepare a written statement including:

- what their investment strategy is;
- how far it is being successfully implemented and any remedial measures the trustees propose;
- any risks and identified ways of mitigating those risks; and
- reflections of the trustees on "important lessons learned" from past investment decisions.

The statement, which will need to be submitted to tPR, must be signed by the chair of the trustee. If there is no chair, trustees will need to appoint one.

It is expected that regulations will confirm the required frequency for drafting such statements and, significantly, any principles to which trustees must adhere when preparing them.

The scheme's technical provisions (or liabilities) will then have to be calculated in a way that is consistent with the scheme's funding and investment strategy. As the deficit recovery plan in place for the scheme is based on the scheme's technical provisions, the new requirements for the LTO are likely to result in sponsors having to pay more into their pension schemes through their deficit recovery plans.

Draft DB Funding Code – the twin-track approach

Among the matters covered by the first consultation was the fast track and bespoke route to compliance with actuarial valuations and the deficit recovery plan. Trustees will be able to choose which route to adopt. They will be able to move between the methods of compliance from valuation to valuation, depending on the circumstances of the scheme and, in practice where the employer's agreement is required in relation to other funding matters, the response of the employer.

Fast track: A set of clear and quantitative compliance guidelines regarding the fast track route will be set out in the new Code. The guidelines will cover matters such as:

- the long-term funding level and its timing;
- technical provisions;
- deficit recovery plans;
- investment risk; and
- future service contribution rates (for schemes that are open to further accrual).

Trustees should comply with these guidelines and, so long as all aspects of the guidelines are satisfied, can expect minimum regulatory involvement in their actuarial valuations.

Bespoke: This option is intended to provide trustees and employers with more flexibility for scheme-specific circumstances or where, for certain reasons, they are unable to comply with fast track. Where trustees follow a bespoke approach, they will have to show the funding arrangements in detail in their statements, giving an explanation as to how and why they have diverged from the fast track method. Trustees will also need to show how they are mitigating any additional risk. They can expect greater regulatory scrutiny with the bespoke route.

Enforcement and penalties

Civil penalties will apply to any trustee who has failed to take all reasonable steps to secure compliance with the requirements for a funding and investment strategy and a written statement on the strategy.

The new criminal offences regime under the Act cover any provision of false or misleading information to tPR in relation to a funding and investment strategy (which would be punishable by a fine and/or up to two years in prison). For further details on the criminal/civil offences, see our first flyer [here](#).

tPR has powers under section 231 of the Pensions Act 2004 to ensure compliance with the scheme funding regime. These powers are expanded under the Act to include a failure by the trustees to comply with any of the new requirements of the funding and investment strategy and tPR has the power to direct trustees to revise their funding and strategy in given circumstances.

In the past, tPR has shown a marked reluctance to exercise its section 231 powers. In the one known case¹ where tPR sought to exercise its powers against the trustee/sponsoring employer of the scheme to put in place a replacement recovery plan and schedule of contributions, it only went as far as issuing a warning notice and later sought to exercise its anti-avoidance powers against the sponsoring employer.

In its response to its consultation on the DB Funding Code, tPR has stated that while it is important for there to be a sufficiently "high bar" to ensuring its section 231 powers are used appropriately and fairly, the lack of clear agreed parameters makes enforcement action around funding unduly inefficient and risks undermining compliance with the law and confidence in the regime.

tPR hopes that providing greater clarity on the funding standards in the DB Funding Code, and putting the onus on trustees to demonstrate that they comply with their legal obligations and to provide this information upfront, will help improve the effectiveness and efficiency of DB regulations.

It remains to be seen whether the implementing regulations and the DB Funding Code will provide sufficient clarity around the requirements of the scheme funding regime for tPR to exercise its section 231 powers more frequently (including directing the trustee to revise its investment and funding strategy and how to do so where there has been a breach of the new requirements).

¹ See tPR's section 89 report for December 2018 in relation to the Southern Water Pension Scheme.

Action point for employers and trustees

Employers	Trustees
Note the new requirements and keep abreast of changes.	Keep abreast of the new requirements and further developments.
Be prepared for a possible increase in deficit repair contributions under the new statutory regime – in particular, in view of the LTO.	Consider training for the trustee board on the new scheme funding requirements.
Expect that scheme trustees will be seeking dialogue over compliance with the long-term funding objective. In most cases, trustees will need the agreement of the employer on this.	Engage with the employer regarding compliance with the new statutory requirements – in particular, consider the LTO and the new funding and investment strategy.
For valuations under way, seek legal and actuarial advice as to what actions should be taken now in view of the LTO.	As for employers and valuations under way, seek legal and actuarial advice as to what actions should be taken now in view of the impending LTO.
When the new requirements have taken effect, the agreement of the employer will be required in most cases in relation to the funding and investment strategy.	<p>When the requirements are in force, trustees will need to:</p> <ul style="list-style-type: none"> • determine a funding and investment strategy (and obtain the agreement of the employer where applicable); • prepare a written statement; • ensure that the scheme’s technical provisions are consistent with the strategy; and • decide on whether a fast track or bespoke route to compliance will be appropriate for the scheme (and ensure that these requirements are met).

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